Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:HMT:[redacted]:1:POSTF-145302-02
[redacted]

date: November 18, 2002

to: [redacted], International Team Manager
Attn: [redacted], International Examiner

from: Associate Area Counsel, (LMSB) [redacted]

---

subject: [redacted], **Inc.**
EIN: [redacted]
Tax Year Ended: [redacted]
Worthless Stock Loss: [redacted]
Bad Debt Deduction: [redacted]

This memorandum responds to your recent request for assistance. This memorandum should not be cited as precedent.

You requested our endorsement of the position you intend to take in disallowing two separate deductions claimed by [redacted], Inc. ([redacted]'s) from foreign operations. Based upon our review of the administrative files, we concur with your proposed disallowance of the two deductions.

Issues

1. Is [redacted] permitted to claim a $[redacted] deduction pursuant to Section 165(g)(3) for the year ended [redacted], associated with stock in [redacted] subsidiaries that operated [redacted] restaurants during [redacted]?

2. Is [redacted] permitted to claim a total of $[redacted] in deductions for the year ended [redacted], under the circumstances described below associated with a subsidiary that operated [redacted] restaurants in [redacted]?

20406

Conclusions

1. [redacted] is not entitled to claim a worthless stock deduction for the year ended [redacted], associated with the [redacted] operations. To the extent [redacted] incurred any loss from the [redacted] business, [redacted] must claim the loss in a later year.

2. [redacted] cannot deduct the $[redacted] (principal balance less value of security) plus $[redacted] (interest receivable) as bad debt deduction, nor can it deduct the $[redacted] payment to a former joint venturer for the year ended [redacted].

Background -- [redacted] Subsidiaries

[redacted] files a consolidated U.S. tax return with other members of the [redacted] affiliated group. [redacted] also holds stock in subsidiaries incorporated outside the United States. In [redacted], [redacted]'s held [redacted]% of the stock in [redacted]. [redacted] held [redacted]% of the stock of [redacted]. [redacted] developed and operated [redacted] restaurants in [redacted] and in other parts of the [redacted]. [redacted] operated [redacted] restaurants in [redacted].

[redacted] files its US tax return based upon a 52/53 week year, and its year end for this period was [redacted] (sometimes called the [redacted] tax return). [redacted] filed its [redacted] tax return in [redacted]. [redacted] claimed a worthless stock deduction associated with the [redacted] subsidiaries on the [redacted] tax return. Nevertheless, [redacted] subsidiaries continued to operate [redacted] restaurants until [redacted], or [redacted] after [redacted] had determined the corporations' stock was worthless. [redacted] did not completely cease operations at that time. It changed its name to [redacted]. On [redacted], [redacted] outside accountants issued audited financial statements for the [redacted] operations for the year ended [redacted]. These financial statements were prepared on a discontinued accounting basis whereby the estimated net recoverable amount of the assets was used in the financial statements instead of historical cost. During [redacted] and [redacted], [redacted] sold off some of the assets of the restaurants and shipped the remaining unsold assets to [redacted].

[redacted] did not commission any formal study of the fair market value of the the stock or assets of [redacted] or [redacted]. Nevertheless, [redacted] valued the loss at $[redacted] for FAS 121 purposes, $[redacted] for financial statement purposes, and $[redacted] for US tax purposes. The tax loss was computed based upon the amount of outstanding intercompany obligations. Over the years, the [redacted] corporations borrowed from the US parent to fund ongoing losses. [redacted] capitalized the obligations, added them to the basis in the stock, and claimed a loss for that amount.

On or about [redacted], a director of [redacted] signed two Forms 8832, "Entity Classification Election", to change the classification of [redacted] from a corporation to a disregarded entity for US tax purposes. The election for [redacted] was retroactive to [redacted], and the election for [redacted] was retroactive to [redacted]. [redacted] liquidated into its parent [redacted]. Two days later, [redacted] liquidated. The consequences of these entity classification changes are reflected on [redacted] tax return.

The change in entity classification, itself, is a deemed liquidation of the [redacted] corporations. Sections 7701 and 367 as well as the related Sections discussed below describe the tax consequences of a liquidation of a foreign corporation. We do not know the extent to which [redacted] seeks to use the accumulated losses of these foreign operations to offset US income or to affect any foreign tax credit computations.

We note that Section 332 can apply to this arrangement. If the [redacted] subsidiaries are not completely worthless when liquidated, Section 332 would prohibit any loss deduction. Section 381 would allow the parent to succeed to the tax attributes of the subsidiaries. You might then want to examine whether the subsidiaries have capitalized any R&E expenses or start-up and carrying charges. Those items would be amortizable later.

You have not requested that we opine on the US parent's ability to use any deficit in E&P or any positive foreign tax pools. (See Sections 381 and 902) You also have made no issue of the foreign or domestic source of any potential loss. You have not challenged the amounts the taxpayer uses in the Section 165(g)(3) computation. Consequently, this memorandum will not address any of those issues.

In discussions with this office, you made clear that you are developing a timing issue, only. You are challenging [redacted] right to claim the loss on the [redacted] return. You do not deny that [redacted] is entitled to some deduction from the discontinued [redacted] operations, at some later time. Nevertheless, your position is that [redacted] is not entitled to any loss deduction in [redacted] under Section 165(g)(3) for the [redacted] operations.

Analysis

For the reasons described below, we endorse your disallowance of the loss claimed by [redacted]. Section 165(a) allows as a deduction any loss sustained during the year not compensated by insurance or otherwise. Under Section 165(g)(1), if any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall be treated as the sale or exchange, on the last day of the taxable year, of a capital asset.

Section 165(g)(3) provides an exception to the general rule of Section 165(g)(1) by allowing ordinary loss treatment for worthless stock held in certain affiliated corporations, even if the stock is a capital asset. To qualify, the taxpayer must meet the requirements found in Section 165(g)(3). We assume the ownership percentage and gross receipts percentage tests have been met.

Section 165(g)(3) has produced substantial controversy and litigation, and a frequently cited opinion interpreting Section 165(g)(3) is Morton v. Commissioner, 38 B.T.A. 1270, 1278-79 (1938), nonacq. 1939-1 C.B. 57, aff'd, 112 F.2d 320 (7th Cir. 1940).

> A loss by reason of the worthlessness of stock must be deducted in the year in which the stock becomes worthless and the loss sustained, that the stock may not be considered worthless even when having no liquidating value if there is a reasonable hope and expectation that it will become valuable at

> some future time, and that such hope and expectation may be foreclosed by the happening of certain events such as the bankruptcy, cessation from doing business, or liquidation of corporation, or the appointment of a receiver for it. Such events are called "identifiable" in that they are likely to be immediately known by everyone having an interest by way of stockholdings or otherwise in the affairs of the corporation; but, regardless of the adjective used to describe them, they are important for tax purposes because they limit or destroy the potential value of stock.
>
> The ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through the foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitely fix the loss... If [the corporation's] assets are less than its liabilities but there is a reasonable hope and expectation that the assets will exceed the liabilities of the corporation in the future, its stock, while having no liquidating value, has a potential value and cannot be said to be worthless. The loss of potential value, if it exists, can be established ordinarily with satisfaction only by some "identifiable event" in the corporation's life which puts an end to such hope and expectation.

Morton established a two-part test for the finding of worthlessness of stock. First, the subsidiary must be insolvent with no liquidating value, i.e., the corporation has an excess of liabilities over assets. Second, the subsidiary must lack potential value. Austin Co. v. Commissioner, 71 T.C. 955, 969-70 (1979), acq. 1979-2 C.B. 1. The stock must be worthless under both factors before the loss is fixed. See Figgie International v. Commissioner, 807 F.2d 59, 62 (6th Cir. 1986).

Regulations promulgated under Section 165 contain many of the requirements quoted above in Morton. Specifically, Treas. Reg. § 1.165-1(b) requires that to be allowable as a deduction under Section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events. See also, Boehm v. Commissioner, 326 U.S. 287, 292 (1945) (upholding validity of regulation). The taxpayer must suffer an economic loss during the year. Commissioner v. Fink, 483 U.S. 89, 97-98 (1987). No loss is allowed unless the stock is wholly worthless. Treas. Reg. § 1.165-5(c) and (f). A mere shrinkage in the value of stock, even though extensive, does not give rise to a deduction under Section 165(a), if the stock has any recognizable value on the date claimed as the date of loss. The burden of showing worthlessness is on the taxpayer. Boehm, 326 U.S. at 294.

We believe your best argument is challenging [redacted] worthless stock deduction is that the [redacted] subsidiaries continued to operate their respective businesses throughout [redacted] and operated [redacted] restaurants until [redacted] which is [redacted] after the date [redacted] claims the stock became worthless. [redacted] claim of worthlessness is premature.

Under Morton, there are two ways of showing lack of potential value, either liabilities so exceed the assets that there is no hope for recovery or by identifiable events demonstrating the worthlessness of the stock. [redacted] has not shown that the [redacted] subsidiaries are so insolvent that there is no hope of recovery. To be sure, the book value of the assets exceeded the book value of the stated liabilities of the [redacted] subsidiaries on that date. However, a closer look at the liabilities might reveal that [redacted] has characterized some equity as debt. We do not know if [redacted] "loans" to these [redacted] subsidiaries were evidenced with a note. Nevertheless, if we successfully recast some portions of the stated debt as equity, [redacted] may no longer be insolvent based upon its balance sheet.

We note that [redacted] capitalized all its outstanding liabilities owed by [redacted] and by [redacted]. These amounts were rolled into the stock basis computation. We do not know when these debts were due. Some of the debts may stretch into later years. Some of the debts were owed to third parties. Those third party debts would not be paid until due, perhaps years later.

[redacted] almost certainly has assets, primarily intangibles, not included in the asset section of the balance sheet. [redacted] going concern value must be considered in determining the value of the subsidiaries assets as of [redacted], the approximate date of liquidation. See Sika Chemical Co. v. Commissioner, 64 T.C. 856, 863 (1975), aff'd without opinion, 538 F.2d 320 (3d Cir. 1976); Hawkins v. Commissioner, T.C. Memo. 1987-91. There may also be some value attached to other intangible assets. See Wally Findlay Galleries International, Inc. v. Commissioner, T.C. Memo. 1996-293.

The second part of the Morton test involves a reasonableness test, would a reasonable businessperson consider that the stock has potential value? Had [redacted] commissioned a fair market value study as of [redacted], we might more seriously consider [redacted] naked claim that the corporation had no potential value. However, [redacted] continued operation of the businesses combined with [redacted] unexplained action of changing the name of [redacted] to [redacted] undercuts [redacted] necessary contention that the businesses had no potential value. In fact, a fair question to raise at this time is whether [redacted] and [redacted] were insolvent and without potential value as of the following year, [redacted], or even the year after that. Would a prudent businessman have considered the stock of the [redacted] subsidiaries worthless on [redacted]? Probably not, and neither do we. The combination of increasing [redacted] assets and recasting some debts as equity might convert [redacted] into a solvent corporation.

Section 385 and case law provide some guidance in determining whether any amounts forwarded by [redacted] to the [redacted] subsidiaries is debt or equity.[1] During the next cycle, you may want to closely examine the [redacted] subsidiaries intercompany obligations owed to [redacted].

[redacted] response to your challenge will include a mention of the fact that the entities were deemed to have liquidated when [redacted] filed the entity classification change. [redacted]

---

[1]Section 385(b) lists the following factors that the regulations may include in making such a determination: (i) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest, (ii) whether there is subordination to or preference over any indebtedness of the corporation, (iii) the ratio of debt to equity of the corporation, (iv) whether there is convertibility into the stock of the corporation, and (v) the relationship between holdings of stock in the corporation and holdings of the interest in question. Because you intend to disallow the taxpayer's claimed loss for reasons other than those contained in Section 385, we will postpone any further discussion of these provisions.

will claim that this is the identifiable event required by Treas. Reg. § 1.165-1 and by the Morton case. By virtue of this deemed liquidation, the assets are deemed to be distributed to the shareholder and, immediately thereafter, used as assets of a [redacted] branch. Treas. Reg. § 301.7701-3(g)(1)(iii). [redacted] anticipated response will be meritless. This deemed liquidation was ruled out as an identifiable event a long time ago. In fact, the Morton decision, supra, dismissed that argument.

The liquidation of the [redacted] subsidiaries was a liquidation in form only. In substance, the "liquidated" corporation continued to operate just as it had before the liquidation. The [redacted] liquidation was accomplished by filing a form with the US tax return which itself was filed in [redacted]. The stock of the insolvent subsidiaries is not worthless simply because the taxpayer makes a check-the-box election and is retroactively "liquidated" for US tax purposes 2 - 3 months earlier.

The recognition event for a worthless stock loss occurs, not when any single identifiable event occurs, but when there is no further ability to recover the taxpayer's investment. Identifiable events act to secure that point in time. In Ditmar v. Commissioner, 23 T.C. 789, 798 (1955), the Service argued that the stock of an unsuccessful company became worthless in the year the company sold its assets and went out of business, both of which are identifiable events listed in Morton. However, the Tax Court agreed with the taxpayer that the stock did not become worthless until the next year when the taxpayer received his last distribution upon liquidation. The court found that this was the identifiable event fixing worthlessness because at that point "there was no prospect that he would receive any more." See Reese Blizzard v. Commissioner, 16 BTA 242 (1929), no recognition event until the final disposition of property by trustees.

Identifiable events must be analyzed in the context in which they occur to determine if they either evidence or cause the utter worthlessness of the stock. Signing and filing a Form 8832 cannot be the identifiable event required by the authorities cited and quoted above. Those authorities used as examples actions like bankruptcy, cessation of business, or liquidation. Frequently, all three events occur at or about the same time. It was possible for [redacted] to undo this singular identifiable event. [redacted] could simply not file the Form 8832. The tax return was not filed until [redacted] or [redacted] after the election was made. Until that time, [redacted] action was reversible.

The [redacted] subsidiaries still held title to the assets of the business long after the [redacted] year end. [redacted] still held the business assets at the end of the next taxable year, [redacted]. We do not agree that [redacted] suffered an identifiable event during the [redacted] year.[2] [redacted] did not make a public statement about closing its operations in the [redacted] until [redacted]. There can be no genuine doubt that had the business improved during the first [redacted] of calendar year [redacted], [redacted] might well still be doing business in the [redacted]. That [redacted] continued to operate the [redacted] stores after [redacted], until [redacted], suggests that [redacted] believed the businesses still had some present or future value.

As of [redacted], there is no known indication to outsiders that the stock of [redacted] and [redacted] is worthless. The employees of the [redacted] subsidiaries probably did not know that their employer was worthless. They, no doubt, continued to work at [redacted] and receive a pay check. We do not know if the stock of the [redacted] subsidiaries was ever cancelled. As a result, we do not see that the check-the-box elections made by [redacted] provide any evidence of the worthlessness of the stock.

Conclusion

For these reasons, we conclude that [redacted] has not established that the stock of the [redacted] subsidiaries was worthless as of [redacted], the year end for the tax year [redacted] seeks to claim the loss. For this reason, we endorse your challenge of [redacted] claimed loss.

---

[2] If an entity is solvent at the time of its liquidation, the parent corporation is not entitled to worthless stock deduction under Section 165(g). Furthermore, a transfer of the subsidiary's assets and liabilities to the parent under section 301.7701-3(g)(1)(iii) generally should qualify as a Section 332 liquidation of subsidiary into a parent if the subsidiary is determined to be solvent at the time of its liquidation. See Treas. Reg. § 1.367(b)-3 and Rev. Rul. 72-421, 1972-2 C.B. 166, for some of the possible consequences of such liquidation.

Background -- [redacted] Joint Venture

On the same tax return that [redacted] claimed the [redacted] worthless stock deduction, [redacted] claimed a total of $[redacted] of deductions related to a joint venture which developed and operated [redacted] restaurants in [redacted]. The $[redacted] is composed of three separate items: a write off of a note receivable from the joint venture partner named [redacted] in the amount of $[redacted]; the interest due on the note in the amount of $[redacted]; and a settlement payment to [redacted] upon termination of the joint venture in the amount of $[redacted]. For the reasons described below, we support your challenge of these three items.

[redacted] claimed the three items identified above as "Other Deductions" on the tax return for the year ended [redacted]. [redacted] has not yet provided an explanation detailing its position with respect to this issue. *We anticipate that this issue will evolve after [redacted] articulates its legal position. For that reason, our endorsement of your position is provisional, and it should be reviewed if you receive more information.*

[redacted] wanted to expand its business in the [redacted] market during the [redacted]. At this time, [redacted], an unrelated company, was operating a successful [redacted]". Sometime around [redacted], [redacted] decided to form a joint venture with [redacted].

[redacted], a [redacted] subsidiary incorporated in Delaware, became one joint venture partner along with [redacted] corporation. Together [redacted] and [redacted] formed [redacted] Corporation, also a [redacted] corporation, and [redacted] corporation. The common stock of [redacted] was divided equally between [redacted] and [redacted] - [redacted] shares each, however, [redacted] also received [redacted] shares of [redacted]'s nonvoting preferred stock. The common stock of [redacted] was divided equally between [redacted] and [redacted] - [redacted] shares each. [redacted] was a holding company the income from which is included in [redacted]'s income pursuant to Subpart F. [redacted]'s income consisted primarily of interest; [redacted]'s assets were notes receivable. [redacted] held the real estate or the leases for the real estate for the restaurants along with the intangibles for the business. We assume the intangibles are related to [redacted]. Another company, [redacted], apparently was the entity which held the assets used to operate the [redacted] and [redacted] restaurants themselves. [redacted] loaned substantial amounts to [redacted] so that [redacted] could purchase the real estate on which the restaurants were located. [redacted] leased the restaurant property from [redacted] and operated the restaurants.

In sum, the joint venture was initially funded with [redacted] cash and [redacted]'s existing restaurants plus some additional cash from [redacted]. The total stated capital contribution to [redacted] of each joint venture partner was $[redacted]. [redacted] loaned $[redacted] to [redacted] which immediately contributed the $[redacted] to the joint venture. The loan required [redacted] to make quarterly repayments of principal and interest. The note was scheduled to be satisfied in [redacted], unless accelerated upon the happening of specific events. The note carried a [redacted]% interest rate ([redacted]% for delinquent interest). The note was a non-recourse promissory note which pledged all of [redacted]'s [redacted] shares of [redacted]'s class A stock as security on the note. Neither [redacted] nor its shareholders agreed to be personally liable for repayment of the loan. [redacted]'s only recourse was against the [redacted] stock held by [redacted].

[redacted] after its formation, the joint venture experienced financial trouble, and the partners disagreed over many aspects of the business. [redacted]'s loan to [redacted] was in default. The loan balance had increased to $[redacted]. You asked the taxpayer about this increasing principal balance. The taxpayer indicated that [redacted] senior management had approved additional loan amounts. We do not have copies of any other notes, loans, or other obligations. [redacted] must have provided the cash and simply increased [redacted]'s obligation under the note. [redacted] reported no interest income after [redacted]. As of [redacted], the accrued and unpaid balance was $[redacted] which is approximately [redacted] of interest.

On [redacted], the parties terminated the joint venture. The parties executed [redacted] agreements which severed the relationship. [redacted] agreements were titled "Settlement Agreements" and were executed by [redacted] and [redacted] and by [redacted] and [redacted]. The [redacted] agreement is titled a [redacted]. That agreement contains the provisions concerning the Non-

Recourse Promissory Note. [redacted] agreed to transfer its [redacted] shares of [redacted]. The agreement then states:

[redacted]

In summary, [redacted] received the business, including the [redacted] stock held by [redacted] and [redacted] was relieved of all liabilities arising from the joint venture. [redacted] paid [redacted] $[redacted] to resolve various disputes concerning the joint venture. The $[redacted] appears to be unrelated to the bad debt, but [redacted] seeks to deduct it as part of the same transaction. The termination agreement does not trace the $[redacted] to any specific claim of [redacted]'s or liability of [redacted]. It appears to us that [redacted] paid $[redacted] as a resolution of all outstanding disputes and to purchase [redacted]'s interest in the joint venture. Any basis [redacted] had in the Non-Recourse Promissory Note would also be part of this purchase transaction.

The non-recourse note was written down to $[redacted] it was not completely written off. As a result, [redacted] did not deduct the entire $[redacted] loan balance. [redacted] deducted $[redacted]. We believe that [redacted] is treating the note as completely worthless and is reducing the bad debt by the $[redacted] collateral -- [redacted] shares of [redacted] stock titled to [redacted] -- to arrive at the $[redacted] amount.

[redacted], [redacted] subsidiary, still wanted to operate a restaurant chain in [redacted]. As part of the termination agreements, [redacted] acquired the [redacted] stock, the restaurant sites and the right to operate the existing restaurants in [redacted], which it did until [redacted]. After that, [redacted] apparently abandoned the [redacted] market.

[redacted] claimed the deductions described above as an other deduction on its consolidated Form 1120 for the [redacted] year. [redacted] booked a $[redacted] loss for financial purposes. The book/tax difference of $[redacted] appeared as a Schedule M-1 adjustment as an expense which reduced book income but not taxable income. You have challenged the deduction on essentially the same grounds that you challenge the deduction for the [redacted] subsidiaries.

In response to your inquiry, [redacted] has cited Section 166, "Bad Debts", as the Code Section which allows these deductions. [redacted] contends, in summary, that the nonrecourse note was worth approximately $[redacted] since [redacted] received the [redacted] shares of [redacted] stock when it foreclosed upon/forgave the debt owed by [redacted]. The difference, $[redacted], plus the $[redacted] accrued interest, is what [redacted] seeks to deduct as a bad debt. [redacted] has not made a different argument or justification for deducting the $[redacted] payment to [redacted] in settlement of other disputes arising from the failed joint venture.

Analysis

We concur with your disallowance of the taxpayer's claimed deduction at this time. [redacted] did not have a bad debt, it had a bad joint venture. The amounts [redacted] lost in the joint venture are probably not deductible until it disposes of the [redacted] stock, and that occurred after [redacted].

Section 166 governs deductions for bad debts, other than a debt evidenced by a corporate or Government security.[3] Section 166(a)(1) provides that a deduction shall be allowed for any debt that becomes worthless within the taxable year. Corporate bad debts give rise to a deduction against ordinary income upon their complete or partial worthlessness. A deductible bona fide debt arises from a debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable sum of money. Treas. Reg. § 1.166-1. There must be a reasonable expectation and intent that repayment will be made. If a shareholder's advance to his corporation is a capital contribution, it becomes part of his investment in the stock. Generally, a capital contribution is an investment placed at the risk of the business. In contrast, a debt is intended to create an

[3]For purposes of Section 166, a security means a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. Sections 166(e) and 165(g)(2)(C) .

obligation which is payable irrespective of the success of the business.

Is this a debt? If so, was it worthless? Whether a payment is equity or a debt is a question of fact to be decided on a case by case basis. See Gilbert v. Commissioner, 262 F.2d 512, 513 (2d Cir. 1959), aff'g. T.C. Memo. 1958-8. Courts have traditionally utilized a number of factors in determining whether an instrument is debt or equity:

1) The names given to the certificates evidencing the debt or equity;

2) The presence or absence of a maturity date;

3) The source of the payments;

4) The right to enforce payment of principal and interest;

5) Participation and management;

6) A status equal to or inferior to that of regular corporate creditors;

7) The intent of the parties;

8) "Thin" or adequate capitalization;

9) Identity of interest between creditor and stockholder;

10) Payment of interest only out of "dividend" money; and

11) Ability to obtain loans from outside lending institutions.

Bauer v. Commissioner, 748 F.2d 1365, 1368 (9th Cir. 1984). No one factor is controlling or decisive, and the court must look to the particular circumstances of each case. "The object of the inquiry is not to count factors, but to evaluate them" Tyler v. Tomlinson, 414 F.2d 844, 848 (5th Cir. 1969). Another recent case is Flint Industries v. Commissioner, T.C. Memo. 2001-276, 2001 TNT 197-9.

We are not going to analyze each of the eleven factors in this memorandum. We will note that [redacted] called the $[redacted] a debt, and [redacted] agreed to that description. Nevertheless, the terms of the debt make it difficult, or impossible, for the debtor to enforce payment absent the success of the joint venture. That makes it look more like equity.

The transactions which occurred at the termination of the joint venture, make the alleged bad debt situation so look more like a purchase of [redacted]'s [redacted] stock. The unpaid nonrecourse loan was never going to be paid by [redacted], it would be paid off from profits from the joint venture. If the joint venture succeeded, the note would be repaid; if it failed, then the note would fail, and [redacted] but not [redacted], would lose financially. You could make a credible argument that the $[redacted] loan was equity, not debt.

Even if the obligation was a debt, we suggest you challenge the timing of the deduction. The joint venture was not dissolved until [redacted]. [redacted] obtained the right to operate the restaurants after that date and did so. We do not know how many payments of interest and principal [redacted] made before the joint venture was dissolved. In fact, we not see how the debt became any more (or less) worthless during the year ended [redacted], compared to the preceding or following year, nor do we see any information concerning the ability of the debtor to repay this debt. After the joint venture was terminated, the debtor received a $[redacted] settlement payment from [redacted]. This debtor appears to be solvent. This looks to us like a buy-out, not a bad debt.

Ultimately, we recommend you take additional action after you determine more about [redacted] position on this matter. We believe the $[redacted] payment made by [redacted] to [redacted] should not be treated as part of any alleged bad debt. The items which really are bad debts appear to have been deducted prematurely. We have substantial questions about the valuation of the security for the debt, [redacted]'s [redacted] shares of [redacted]'s common stock. For these reasons, we endorse your challenge of the bad debt deduction and the deduction of the $[redacted] payment.

Conclusion

We endorse your disallowance of the three items which constitute [redacted] $[redacted] bad debt deduction for the year ended [redacted]. We recognize that [redacted] could provide some additional information in support of their case or articulate a theory which might allow for the deduction of some or all of this amount. For that reason, our endorsement is provisional, only. Nevertheless, we would be receptive to further consultation on this issue should [redacted] provide additional information. Should you have questions about this memorandum, please contact [redacted].

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views

[redacted]
Associate Area Counsel (LMSB)

By:____________________
[redacted]
Senior Attorney (LMSB)